Waiter! There's A Bear In My Bonds!

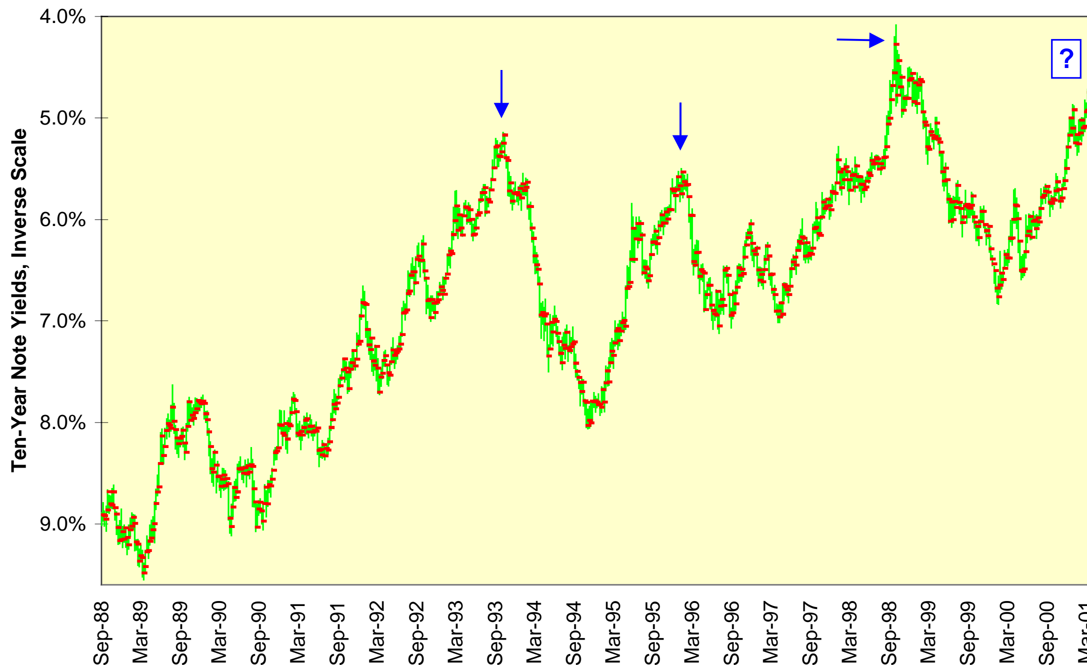
You don't tug on Superman's cape, you don't spit in the wind, you don't pull the mask off the Lone Fed Chairman, and you certainly don't buy bonds in the face of rising yields. Bear markets in stocks make for scarier headlines and certainly bruise a lot more egos, but bear markets in bonds can be just as bad. After all, you can always sell a dream in stocks; they have an earnings growth as well as an interest rate component. Treasury bonds, however, simply surf the interest rate waves and can neither grow their way out of trouble nor acquire higher P/Es. Risk-seekers in the world of fixed income must be content to bid corporate bonds to imprudently narrow spreads.

An odd model of the impending economy and financial markets is suggested. Think of the hot economy of the late 1990s as a raging campfire, and of the rate hikes of the 1999-2000 period as a bucket of water tossed casually thereon. Some parts of the wood – the tech and telecom sectors – got soaked, but others remained hot and smoldering. Now, extend the analogy to the ongoing loosening as a bucket of gasoline. Sectors such as housing, autos, and basic industries are about to reignite while the tech sector will lag. Credit demands will surge, bonds will tank, and stocks will outperform until everyone gets the sense the Fed will begin raising rates again, say in 2002. The history and logic behind this scenario is presented below.

Bond Bear History Under Greenspan

The interest rate history of the Greenspan era is, in the very broadest sense, one of disinflation and lower yields. Chartists may note below how recent highs in note yields have been less than the lows of note yields in the early 1990s (the yield scale on the charts below is inverted to parallel bond price movements). After the bond market debacle of 1987, a self-inflicted wound produced by haphazard currency interventions against the U.S. dollar from February 1985 onward, and after the October 1987 crash, the Greenspan Fed set about to wring inflationary expectations out of the system. Aided by the mild recession of the early 1990s and a contractionary fiscal policy – Presidents Bush and Clinton raised taxes in 1990 and 1993, respectively – the yield on 10-year notes fell from 9.5% in March 1989 to 5.15% in September 1993.

Bond Breaks Of The Greenspan Era



But, the Fed's long policy of low interest rates – the federal funds rate remained at 3% from August 1992 to February 1994 – helped stimulate both the economy and inflationary expectations. The worst bond market since 1927 began in September 1993, well before the Fed's first 25 basis points hike in the federal funds rate in February 1994.

Two other bond bear markets emerged in the 1990s, and are marked on the above chart. One began in January 1996, in the immediate aftermath of a cut in the federal funds rate to 5.25%. The other began in October 1998, just prior to the second, surprise, rate cut associated with the Russian financial crisis. The three bond market breaks all began at different points in the Fed's rate cycle. The September 1993 break began five months before tightening commenced, the January 1996 break came after a small relaxation, and the October 1998 break began prior to the second of the Fed's three 25 basis point rate cuts in the fall of 1998.

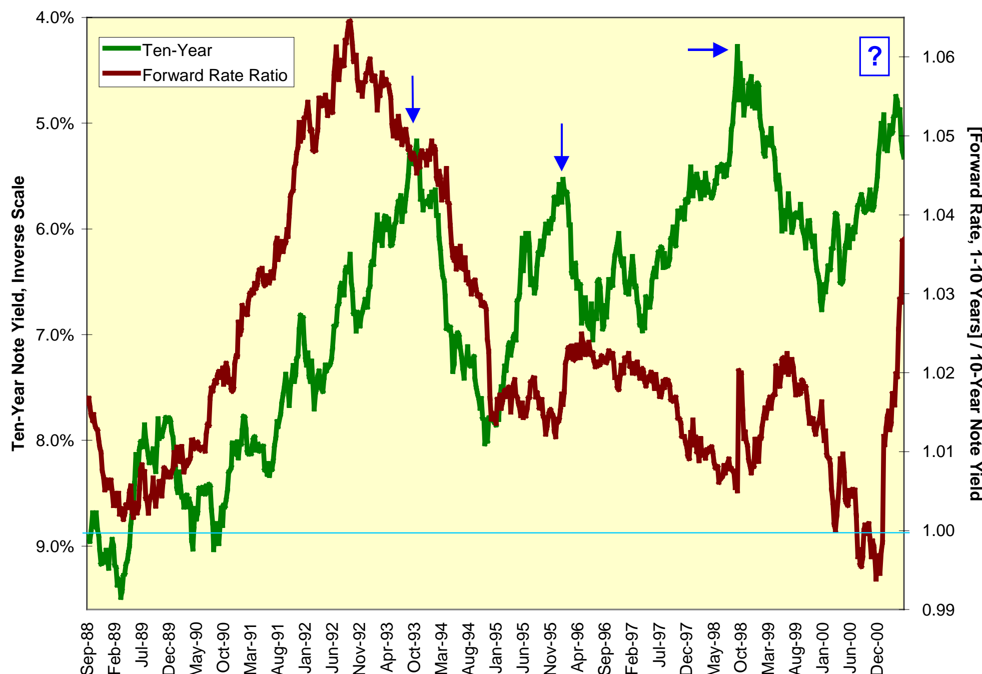
The Present Situation

The common link between the current market and these recent bond market breaks is anticipation of stronger economic growth ahead. Let's emphasize the word "growth," not "inflation." Despite the truly uninformed commentary heard elsewhere, there is not now nor has there ever been any evidence of growth causing inflation. Growth will lead to increased credit demands, however, and that will raise interest rates, the price of money.

The bond market anticipated the economic recovery of 1994, the continuation of growth in 1996, and the avoidance of a global catastrophe in 1998 correctly; none of these periods were characterized by high inflationary expectations. While we're passing out kudos to the bond market, let's note bond yields peaked in late January 2000, the very time when many stock traders thought the good times just might last forever. This year, both bond yields and the stock market bottomed simultaneously on March 22, which suggests a simultaneous realization of avoided catastrophe.

But, as much as we study history, we must recognize every market is unique. Let's add the dimension of the yield curve to past bond market breaks. The shape of the curve will be defined here as the ratio between the forward rate from one to ten years to the ten-year note rate itself. The higher the ratio the more positively-sloped the yield curve, and the worse the timing to go long in the bond market. The 1993 bear market began during a flattening phase of the yield curve, while the 1996 and 1998 bear markets began as yield curves ceased steepening.

A Unique Situation At Present



The current steepening of the yield curve; indeed, the transformation from an inverted curve to a steep curve, is unprecedented in the Greenspan era. If the avoided catastrophe scenario is correct, the monetary stimulus will in fact constitute pouring gasoline on the fire. Even worse, we may get a combination of the bond bear market environments of 1993 and 1998, a flattening of the yield curve and the resumption of strong growth. If so, we could be headed for one of the worst bond markets in memory, one that will eventually take both stocks and the economy along for the downwards ride.